

# 2008 Instructions for Schedule M-3

## Net Income (Loss) Reconciliation for Certain Partnerships and Limited Liability Companies

References in these instructions are to the Internal Revenue Code (IRC) as of **January 1, 2005**, and to the California Revenue and Taxation Code (R&TC).

### What's New

**For Certain Partnerships and Limited Liability Companies** – For taxable years beginning on or after January 1, 2008, certain partnerships and Limited Liability Companies (LLCs) are required to complete California Schedule M-3 (565/568), Net Income (Loss) Reconciliation for Certain Partnerships and Limited Liability Companies, instead of Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return.

### General Information

In general, California law conforms to the Internal Revenue Code (IRC) as of January 2005. However, there are continuing differences between California and federal law. When California conforms to federal tax law changes, we do not always adopt all of the changes made at the federal level. For more information regarding California and federal law, please visit our website at [ftb.ca.gov](http://ftb.ca.gov) and search for **conformity**. Additional information can be found in FTB Pub 1001, Supplemental Guidelines to California Adjustments, the instructions for California Schedule CA (540 or 540NR), and the Business Entity tax booklets. **Note:** the instructions provided with California tax forms are a summary of California tax law and are only intended to aid taxpayers in preparing their state income tax returns. We include information that is most useful to the greatest number of taxpayers in the limited space available. It is not possible to include all requirements of the California Revenue and Taxation Code (R&TC) in the tax booklets. Taxpayers should not consider the tax booklets as authoritative law.

### A Purpose

Schedule M-3, Part I asks certain questions about the partnership's or Limited Liability Company's (LLC) financial statements and reconciles financial statement net income (loss) for the consolidated financial statement group to income (loss) per the income statement for the partnership or LLC. Use federal Schedule M-3 (Form 1065 or 1065-B), Part I amounts to complete California Schedule M-3, Part I.

Schedule M-3, Part II and Part III reconcile financial statement net income (loss) to income (loss) per return. Adjustments consistent with California income and franchise tax law must be made to the book income and expenses to compute the California income (loss).

### B Who Must File

Any Partnerships or LLCs subject to California laws must complete and file Schedule M-3, Net Income (Loss) Reconciliation For Certain Partnerships and Limited Liability Companies, instead of Form 565 or Form 568,

Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, if a federal Schedule M-3 (Form 1065 or 1065-B) is filed.

Disregarded entities should not separately file this schedule. The income, assets, liabilities and capital of disregarded entities should be included with their owners for determining the filing requirements for this form.

If for any taxable year (or taxable years) prior to the first taxable year a partnership or LLC is required to file Schedule M-3, a partnership or LLC voluntarily files Schedule M-3 instead of Schedule M-1, then in those voluntary filing years, the partnership or LLC is not required to complete columns (a) and (d) of Parts II and III. In addition, for the first tax year the partnership or LLC is required to file Schedule M-3, they are not required to complete columns (a) and (d) of Parts II and III. See the federal Schedule M-3 (Form 1065 or 1065-B) instructions for additional requirements.

For more information regarding "Who Must File" and filing requirements examples, see federal Schedule M-3 (Form 1065 or 1065-B) instructions.

The term "partnership" used in the federal Schedule M-3 (Form 1065 or 1065-B) Instructions includes LLCs that are taxed as partnerships. Additionally, the term "partner" includes members, when reference is made to LLCs.

### Instructions for Part I – Financial Information and Net Income (Loss) Reconciliation

Complete Part I for any taxable year for which the partnership or LLC files federal Schedule M-3. Follow the federal Schedule M-3 (Form 1065 or 1065-B) instructions "Specific Instructions for Part I" to complete Lines 1 through 12. Use the methodology and amounts reported on federal Schedule M-3 (Form 1065 or 1065-B), Part I to complete California Schedule M-3, Part I.

### Instructions for Parts II and III

#### General Reporting Requirements

Follow federal Schedule M-3 (Form 1065 or 1065-B) requirements listed under Parts II and III for amounts to include under columns (a) through (d). Include all supporting schedules required to be included with the federal Schedule M-3 (Form 1065 or 1065B).

Attach a copy of federal form 8916-A, Supplemental Attachment to Schedule M-3, to support any amounts on Part II, line 11, Interest income; Part II, line 15, Cost of goods sold; or Part III, line 27, Interest expense.

#### Columns (a) through (d)

To complete Schedule M-3 (565/568), Part I and Part II, column (a) through column (d), the

partnership or LLC must apply the following rules:

- Completion of column (a) and column (d) is optional for the first year in which the Schedule M-3 is required for federal purposes.
- Columns (b) and (c) of Part II and Part III must be completed for any tax year in which the partnership or LLC files Schedule M-3.
- The partnership or LLC must complete columns (a) through (d) of Part II and Part III for all taxable years subsequent to the first taxable year the partnership or LLC is required to file Schedule M-3 for federal purposes.
- If a partnership or LLC voluntarily files Schedule M-3 instead of Schedule M-1, then in those voluntary filing years, the partnership or LLC is not required to complete columns (a) and (d) of Part II and Part III.
- Transfer the amounts reported on federal Schedule M-3 (Form 1065 or 1065-B), Part II and Part III, columns (a) through (d) to Schedule M-3, Part II and III, columns (a) through (d). See federal Schedule M-3 (Form 1065 or 1065-B) instructions for Part II and Part III for additional information.

#### Column (e) California Adjustments

Enter the adjustments resulting from differences between California and federal tax law for each specific line item. All adjustments reported in column (e) should be adjustments related to differences in tax laws. Therefore, do not include adjustments for amounts not apportioned or sourced to California.

**Note:** The differences between California and federal law identified in these instructions are not all-inclusive.

#### Column (f), Total Amounts Using California Law

Combine each line item of column (d) and column (e); enter the total in column (f). This is the total amount under California tax law. The totals in column (f) do not reflect amounts that are apportioned or sourced to California. Column (f) should be completed when column (d) is required to be completed.

### Instructions for Part II – Reconciliation of Net Income (Loss) per Income Statement of Partnership and LLC's With Income (Loss) per Return

#### Specific line instructions

Use the amounts reported on federal Schedule M-3 (Form 1065 or 1065-B), Part II, lines 1 through 26, columns (a) through (d), to complete California Schedule M-3, Part II, lines 1 through 26, columns (a) through (d).

See General Information F, How to complete Part II and Part III, for more information.

**Note:** The differences between California and federal law identified in these instructions are not all-inclusive.

**Line 2 – Gross Foreign Dividends Not Previously Taxed**

Enter on line 2, column (e), adjustments for any gross foreign dividends reported on other lines.

**Line 3a – Subpart F, QEF, and Similar Income Inclusions**

California does not conform to Subpart F or the federal passive foreign investment company rules. Enter the amount reported on line 3a, column (d), as an adjustment in column (e).

**Line 3b – Income for California Purposes from Foreign Corporations**

California does not conform to Subpart F or the federal passive foreign investment company rules; enter income from foreign corporations in column (e) to the extent not reported on line 2.

**Lines 7, 8, and 9 – Income (loss) from U.S. and Foreign partnerships and other pass through entities**

For each partnership or other pass through entity reported on lines 7, 8, or 9, attach a supporting schedule that provides the entities name, EIN (if applicable), the taxpayers end of year profit-sharing percentage (if applicable), and the amounts reported by the taxpayer in column a, b, c, d, e and f, as applicable. Enter the differences in column (e).

**Line 11 – Interest income**

Attach a copy of federal form 8916-A, Supplemental Attachment to Schedule M-3. See FTB Pub. 1001 for examples of differences between federal and California law. Enter the differences in column (e).

**Line 15 – Cost of Goods Sold**

Attach a copy of federal form 8916-A, Supplemental Attachment to Schedule M-3. California does not conform to IRC Section 198(h), relating to termination, and expensing of environmental remediation costs after 12/31/2003. See R&TC Section 17279.4. Enter the differences in column (e).

**Line 17 – Section 481(a) Adjustments**

Generally, an election to use a method of accounting for federal purposes is considered an election for California purposes as well. However, there are some exceptions. See R&TC Section 17551. Enter the differences in column (e).

**Line 19 – Income Recognition From Long-Term Contracts**

California generally conforms to IRC Section 460. See R&TC Section 17564 for modifications to IRC Section 460. Enter the differences in column (e).

**Line 21b – Gross Capital Gains Excluding Amounts From Pass-Through Entities; attach Schedule D**

**Line 21c – Gross Capital Losses Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses; attach Schedule D**

**Line 21d – Net Gain/Loss Excluding Amounts From Pass-Through Entities, Abandonment Losses, and Worthless Stock Losses; attach Schedule D-1**

See FTB Pub. 1001 for examples of differences between federal and California law. Enter the differences in column (e).

**Instructions for Part III – Reconciliation of Net Income (Loss) per Income Statement of Partnerships and LLC's With Income (Loss) per Return – Expense/ Deduction Items**

**Specific line instructions**

Use the amounts reported on federal Schedule M-3 (Form 1065 or 1065-B), Part III columns (a) through (d) to complete California Schedule M-3, Part III, lines 1 through 30, columns (a) through (d). See General Information F, How to complete Part II and Part III, for more information.

**Note:** The differences between California and federal law identified in these instructions are not all-inclusive.

**Lines 1 Through Line 4 – Income Tax Expense**

California does not allow a deduction for state or foreign taxes measured by income. Enter on lines 1 through 4, column (e), any deductions allowed for federal purposes for state or foreign taxes measured by income.

**Line 10 – Pension and Profit Sharing**

See R&TC Sections 17501 through 17510 for differences between federal and California law. Enter the differences in column (e).

**Line 12 – Deferred Compensation**

See R&TC Sections 17501 through 17510 for differences between federal and California law. Enter the differences in column (e).

**Line 22 – Section 198 Environmental Remediation Costs**

California does not conform to IRC Section 198(h), relating to termination and expensing of environmental remediation costs after 12/31/2003. See R&TC Section 17279.4. Enter the differences in column (e).

**Line 25 – Depreciation**

Enter on line 25 any depreciation expense that is not reportable elsewhere on Schedule M-3 (Part II, lines 7, 8, 9, or 15). See FTB Pub. 1001 for examples of differences between federal and California law for depreciation and other expense/deduction items. Enter in column e, differences in depreciation between federal and state laws.

**Line 27 – Interest Expense**

Attach a copy of federal form 8916-A, Supplemental Attachment to Schedule M-3.

**Line 29 – Other Expense/ Deduction Items With Differences**

See FTB Pub. 1001. Enter the differences in column (e).